

	1994	1995	1996	Average
Assets .....	\$24,000	\$25,000	\$26,000	\$25,000
Sales to MarkCo .....	25,000	30,000	35,000	30,000
Cost of Goods Sold .....	6,250	7,500	8,750	7,500
Royalty to DevCo (5%) .....	1,250	1,500	1,750	1,500
Other .....	5,000	6,000	7,000	6,000
Operating Expenses .....	1,000	1,000	1,000	1,000
Operating Profit .....	17,750	21,500	25,250	21,500

(v) Applying the ratios of average operating profit to operating assets for the 1994 through 1996 taxable years derived from a group of similar uncontrolled comparables located in country M and N to ManuCo's average operating assets for the same period provides a set of comparable operating profits. The interquartile range for these average comparable operating profits is \$3,000 to \$4,500. ManuCo's average reported operating profit for the years 1994 through 1996 (\$21,500) falls outside this range. Therefore, the district director determines that an allocation may be appropriate for the 1996 taxable year.

(vi) To determine the amount, if any, of the allocation for the 1996 taxable year, the district director compares ManuCo's reported operating profit for 1996 to the median of the comparable operating profits derived from the uncontrolled distributors' results for 1996. The median result for the uncontrolled comparables for 1996 is \$3,750. Based on this comparison, the district director increases royalties that ManuCo paid by \$21,500 (the difference between \$25,250 and the median of the comparable operating profits, \$3,750).

*Example 5—Adjusting operating assets and operating profit for differences in accounts receivable.* (i) USM is a U.S. company that manufactures parts for industrial equipment and sells them to its foreign parent corporation. For purposes of applying the comparable profits method, 15 uncontrolled manufacturers that are similar to USM have been identified.

(ii) USM has a significantly lower level of accounts receivable than the uncontrolled manufacturers. Since the rate of return on capital employed is to be used as the profit level indicator, both operating assets and operating profits must be adjusted to account for this difference. Each uncontrolled comparable's operating assets is reduced by the amount (relative to sales) by which they exceed USM's accounts receivable. Each uncontrolled comparable's operating profit is adjusted by deducting imputed interest income on the excess accounts receivable. This imputed interest income is calculated by multiplying the uncontrolled comparable's excess accounts receivable by an interest rate appropriate for short-term debt.

*Example 6—Adjusting operating profit for differences in accounts payable.* (i) USD is the U.S. subsidiary of a foreign corporation. USD

purchases goods from its foreign parent and sells them in the U.S. market. For purposes of applying the comparable profits method, 10 uncontrolled distributors that are similar to USD have been identified.

(ii) There are significant differences in the level of accounts payable among the uncontrolled distributors and USD. To adjust for these differences, the district director increases the operating profit of the uncontrolled distributors and USD to reflect interest expense imputed to the accounts payable. The imputed interest expense for each company is calculated by multiplying the company's accounts payable by an interest rate appropriate for its short-term debt.

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#### § 1.482-6 Profit split method.

(a) *In general.* The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The combined operating profit or loss must be derived from the most narrowly identifiable business activity of the controlled taxpayers for which data is available that includes the controlled transactions (relevant business activity).

(b) *Appropriate share of profits and losses.* The relative value of each controlled taxpayer's contribution to the success of the relevant business activity must be determined in a manner that reflects the functions performed, risks assumed, and resources employed by each participant in the relevant business activity, consistent with the comparability provisions of § 1.482-1(d)(3). Such an allocation is intended to correspond to the division of profit or loss that would result from an arrangement between uncontrolled taxpayers, each performing functions

similar to those of the various controlled taxpayers engaged in the relevant business activity. The profit allocated to any particular member of a controlled group is not necessarily limited to the total operating profit of the group from the relevant business activity. For example, in a given year, one member of the group may earn a profit while another member incurs a loss. In addition, it may not be assumed that the combined operating profit or loss from the relevant business activity should be shared equally, or in any other arbitrary proportion. The specific method of allocation must be determined under paragraph (c) of this section.

(c) *Application*—(1) *In general*. The allocation of profit or loss under the profit split method must be made in accordance with one of the following allocation methods—(i) The comparable profit split, described in paragraph (c)(2) of this section; or

(ii) The residual profit split, described in paragraph (c)(3) of this section.

(2) *Comparable profit split*—(i) *In general*. A comparable profit split is derived from the combined operating profit of uncontrolled taxpayers whose transactions and activities are similar to those of the controlled taxpayers in the relevant business activity. Under this method, each uncontrolled taxpayer's percentage of the combined operating profit or loss is used to allocate the combined operating profit or loss of the relevant business activity.

(ii) *Comparability and reliability considerations*—(A) *In general*. Whether results derived from application of this method are the most reliable measure of the arm's length result is determined using the factors described under the best method rule in § 1.482-1(c).

(B) *Comparability*—(1) *In general*. The degree of comparability between the controlled and uncontrolled taxpayers is determined by applying the comparability provisions of § 1.482-1(d). The comparable profit split compares the division of operating profits among the controlled taxpayers to the division of operating profits among uncontrolled taxpayers engaged in similar activities under similar circumstances. Although

all of the factors described in § 1.482-1(d)(3) must be considered, comparability under this method is particularly dependent on the considerations described under the comparable profits method in § 1.482-5(c)(2), because this method is based on a comparison of the operating profit of the controlled and uncontrolled taxpayers. In addition, because the contractual terms of the relationship among the participants in the relevant business activity will be a principal determinant of the allocation of functions and risks among them, comparability under this method also depends particularly on the degree of similarity of the contractual terms of the controlled and uncontrolled taxpayers. Finally, the comparable profit split may not be used if the combined operating profit (as a percentage of the combined assets) of the uncontrolled comparables varies significantly from that earned by the controlled taxpayers.

(2) *Adjustments for differences between the controlled and uncontrolled taxpayers*. If there are differences between the controlled and uncontrolled taxpayers that would materially affect the division of operating profit, adjustments must be made according to the provisions of § 1.482-1(d)(2).

(C) *Data and assumptions*. The reliability of the results derived from the comparable profit split is affected by the quality of the data and assumptions used to apply this method. In particular, the following factors must be considered—

(1) The reliability of the allocation of costs, income, and assets between the relevant business activity and the participants' other activities will affect the accuracy of the determination of combined operating profit and its allocation among the participants. If it is not possible to allocate costs, income, and assets directly based on factual relationships, a reasonable allocation formula may be used. To the extent direct allocations are not made, the reliability of the results derived from the application of this method is reduced relative to the results of a method that requires fewer allocations of costs, income, and assets. Similarly, the reliability of the results derived from the application of this method is affected

by the extent to which it is possible to apply the method to the parties' financial data that is related solely to the controlled transactions. For example, if the relevant business activity is the assembly of components purchased from both controlled and uncontrolled suppliers, it may not be possible to apply the method solely to financial data related to the controlled transactions. In such a case, the reliability of the results derived from the application of this method will be reduced.

(2) The degree of consistency between the controlled and uncontrolled taxpayers in accounting practices that materially affect the items that determine the amount and allocation of operating profit affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect operating profit, the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, accounting consistency among the participants in the controlled transaction is required to ensure that the items determining the amount and allocation of operating profit are measured on a consistent basis.

(D) *Other factors affecting reliability.* Like the methods described in §§ 1.482-3, 1.482-4, and 1.482-5, the comparable profit split relies exclusively on external market benchmarks. As indicated in § 1.482-1(c)(2)(i), as the degree of comparability between the controlled and uncontrolled transactions increases, the relative weight accorded the analysis under this method will increase. In addition, the reliability of the analysis under this method may be enhanced by the fact that all parties to the controlled transaction are evaluated under the comparable profit split. However, the reliability of the results of an analysis based on information from all parties to a transaction is affected by the reliability of the data and the assumptions pertaining to each party to the controlled transaction. Thus, if the data and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of

that party, may yield more reliable results.

(3) *Residual profit split*—(i) *In general.* Under this method, the combined operating profit or loss from the relevant business activity is allocated between the controlled taxpayers following the two-step process set forth in paragraphs (c)(3)(i)(A) and (B) of this section.

(A) *Allocate income to routine contributions.* The first step allocates operating income to each party to the controlled transactions to provide a market return for its routine contributions to the relevant business activity. Routine contributions are contributions of the same or a similar kind to those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns. Routine contributions ordinarily include contributions of tangible property, services and intangibles that are generally owned by uncontrolled taxpayers engaged in similar activities. A functional analysis is required to identify these contributions according to the functions performed, risks assumed, and resources employed by each of the controlled taxpayers. Market returns for the routine contributions should be determined by reference to the returns achieved by uncontrolled taxpayers engaged in similar activities, consistent with the methods described in §§ 1.482-3, 1.482-4 and 1.482-5.

(B) *Allocate residual profit.* The allocation of income to the controlled taxpayers' routine contributions will not reflect profits attributable to the controlled group's valuable intangible property where similar property is not owned by the uncontrolled taxpayers from which the market returns are derived. Thus, in cases where such intangibles are present there normally will be an unallocated residual profit after the allocation of income described in paragraph (c)(3)(i)(A) of this section. Under this second step, the residual profit generally should be divided among the controlled taxpayers based upon the relative value of their contributions of intangible property to the relevant business activity that was not